

VZCZCXR05958
RR RUEHCN RUEHGH RUEHVC
DE RUEHGZ #0704/01 3620107

ZNR UUUUU ZZH
R 280107Z DEC 09
FM AMCONSUL GUANGZHOU
TO RUEHC/SECSTATE WASHDC 1215
INFO RUEHOO/CHINA POSTS COLLECTIVE 0402
RUEHBJ/AMEMBASSY BEIJING 0976
RUEHGH/AMCONSUL SHANGHAI 0329
RUEHCN/AMCONSUL CHENGDU 0330
RUEHSH/AMCONSUL SHENYANG 0339
RUEHHK/AMCONSUL HONG KONG 0393
RUEHIN/AIT TAIPEI 0294
RUEHML/AMEMBASSY MANILA 0032
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC 0125
RULSDMK/DEPT OF TRANSPORTATION WASHINGTON DC 0023
RUEATRS/DEPT OF TREASURY WASHINGTON DC 0218

UNCLAS SECTION 01 OF 03 GUANGZHOU 000704

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DEPT OF TRANSPORTATION PASS TO SMCDERMOTT, JSZABAT, KGLATZ

E.O. 12958: N/A
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SUBJECT: Express Delivery Hubs Find New Home in South China, But Not Without Challenges

REF: Beijing 795

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¶1. (SBU) Summary: Situated within three hours flight time from most major cities in the Asia-Pacific region, the Pearl River Delta (PRD) is an excellent hub for logistic companies serving this part of the world, according to express delivery firms. FedEx and UPS are both positioning themselves to enhance their logistic networks in Asia and further penetrate the growing China market by establishing Asia-Pacific hubs in the PRD. Despite support from local governments for the new hubs, the two firms face multiple regulatory challenges. In addition to China's new Postal Law, which ostensibly limits the business scope of delivery service firms, FedEx and UPS have also encountered difficulties related to flight schedules and ground transport restrictions that affect their hub operations. End summary.

Express Delivery Hubs Sprout in the PRD

¶2. (SBU) South China is very attractive for the logistics business because it is the world's manufacturing base, said FedEx Managing Director for South China Robert Chu. Chu told the Consul General and ConGenOffs that the PRD offers international opportunities that surpass even the Yangtze River Delta, which has only one international airport in Shanghai versus the three (Hong Kong, Guangzhou, and Shenzhen) that service the PRD. For these and other reasons, FedEx moved its Asia-Pacific hub from Subic Bay, Philippines to Guangzhou's Baiyun Airport in February 2009, said Chu.

¶3. (SBU) UPS is also moving its intra-Asia hub from Clark, Philippines to Shenzhen. Centrally located for intra-Asia logistic transport, UPS expects the hub to improve service efficiency and reduce network costs. The new hub will take over as UPS's gateway to south China, said company executives. UPS Director for South China Ivy Yang told the Consul General that the hub is on schedule to begin operations in the first quarter of 2010. Besides FedEx and

UPS, Dutch parcel delivery company TNT is also investing in a new hub in Hong Kong, according to industry experts.

Local Governments Cooperative

¶ 14. (SBU) With no previously established laws or regulations specifically governing hub operations in Guangzhou, FedEx worked closely with the local government and customs authorities to develop related regulations for its new hub, said Chu. He explained that the government was willing to learn about FedEx's operations and experiences at other hubs. Similarly, UPS Asia-Pacific Region Vice President Steven Okun expressed that he had been impressed by the level of cooperation shown by the Shenzhen government towards UPS throughout the establishment of the hub. Additionally, UPS executives said that the Shenzhen government had also been supportive of UPS's position on several outstanding issues related to flight schedules and business registration status.

In the "Right Market"

¶ 15. (SBU) FedEx is optimistic about the logistics market in south China. The Chinese government is investing a lot to boost domestic spending, so the situation is quite good, said Chu. FedEx's China business is actually outperforming its international service in terms of growth. Internationally, volumes are slowly returning to pre-downturn levels for the company, and the trend is expected to be stable through the Lunar New Year Holiday, according to Chu. The rebound in the last few months has been V-shaped both in terms of volume and customer growth, he said. (Comment: This trend is likely due in large part to businesses' efforts to maintain inventories ahead of Christmas and Chinese New Year. Whether the growth is sustainable after February 2010 will largely depend on U.S.

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inventory levels at that time. End comment.) "We are in the right market," Chu repeatedly said to the Consul General, adding that the Asia-Pacific market is solid, especially China.

Postal Law, Flight Schedules and Other Restrictions

¶ 16. (SBU) While market indicators are positive, the two companies still face regulatory hurdles that limit operational efficiency in south China. Besides the recently implemented national Postal Law, which significantly limits the business scope and competitiveness of foreign express delivery firms, other obstacles include flight schedule approvals and ground transport restrictions, said the two firms' executives.

¶ 17. (SBU) The Civil Aviation Authority of China (CAAC) continues to deny co-terminalization--the right to serve two specified points on the same flight and route in the territory of a party to an air transport services agreement--for FedEx flights related to Guangzhou, FedEx Vice President for International Affairs Alan Turley told the Minister Counselor for Economic Affairs during a December 2 visit to the new Guangzhou hub. The CAAC cites airspace congestion between Zone 1 airports (Beijing, Shanghai, and Guangzhou) as the reason for their decision, arguing that it is warranted under the U.S.-China Air Transport Agreement (ATA) as a technical measure, according to Turley. Furthermore, Turley said the CAAC considered the FedEx co-terminalization flights it has already approved to be a compromise, so the agency is holding firm on its rejection of further co-terminalization requests. However, FedEx believes that multiple co-terminalization is consistent with the benefits of cargo hub status under the ATA. Without co-terminalization for flights related to Guangzhou, FedEx operations are significantly restricted, said Turley. (Note: State EEB/TRA/AN and Department of Transportation held a second round of consultations with CAAC on Dec. 2-3 in Beijing regarding the FedEx co-terminalization issue.)

¶ 18. (SBU) Another challenge for FedEx's hub operation involves its contract with the Guangzhou Airport Company, which leases the hub facilities to FedEx. According to Turley, the contract is not final

because such status is contingent on the resolution of some customs-related issues, which are still being worked out. Consequently, fees and rates for the hub have not been established and the Guangzhou Airport Company has been providing FedEx with estimates. Turley said that FedEx would like to operate under a finalized lease as soon as possible.

¶9. (SBU) With its hub opening target date approaching, UPS is also awaiting approval from the CAAC for its requested slots at Shenzhen Airport. According to UPS's Yang, the CAAC is reluctant to approve UPS's schedule because Shenzhen Airport, which has only one runway, has reached capacity in its daytime schedule, defined as 6am to 2am.

Because some UPS flights would arrive prior to 2am, some of the requested slots are considered daytime slots by the CAAC. As an alternative, UPS has also requested that the CAAC approve a transfer of slots with Shenzhen Airlines whereby UPS gets a daytime slot at Shenzhen Airport and Shenzhen Airlines gets UPS's slot at Guangzhou Airport, said UPS's Okun in a separate meeting with ConGenOffs. If approved, the transfer would be the first of its kind. Although Okun said that Shenzhen's vice mayor supported the transfer proposal, he also speculated that the CAAC would likely view it as a policy issue and wish to avoid any indication that it was setting a precedent for the commercialization of runway slots. (Note: UPS has indicated it will invite the Ambassador to attend the formal opening ceremony once dates are set.)

¶10. (SBU) Cross-border trucking and customs registration are two other outstanding issues that UPS is working to resolve in order to ensure its hub runs smoothly and effectively when it opens in early ¶2010. Yang told Consul General that UPS is trying to obtain permits from the Guangdong government for cross-border trucking of parcels between Hong Kong and Guangdong in an attempt to better connect its Hong Kong network to the new hub. Shenzhen Customs has expressed support for the trucking permit, according to Yang. However, because foreign-operated trucks are not allowed on interstate highways, the provincial government has yet to accommodate UPS's

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request. Separately, Shenzhen Customs has said that it is unwilling to accept the current UPS hub wholly-owned foreign enterprise business scope as sufficient for UPS to run "terminal operations," said Yang. She added that the Shenzhen government had expressed willingness to persuade Shenzhen Customs to accept this status.

UPS Recommendations to Guangdong Officials

¶11. (SBU) In light of these issues, UPS made recommendations to the Guangdong government via the International Consultative Conference on the Future Economic Development of Guangdong Province (ICCFED), a meeting of senior provincial officials with international business leaders held in Guangzhou in November, said Yang. Specifically, Daniel Brutto, president of UPS International, lobbied for 1) improvements to the hard and soft infrastructure of airports, emphasizing the need to address the tight airspace in the PRD; 2) strengthened integration between Guangdong and Hong Kong through development of cross-border trucking services; 3) development of a multi-modal transportation system by first addressing the issues of daytime inner city access for express delivery vehicles and temporary parking facilities; 4) strengthened customs facilitation of goods movement in Guangdong; and 5) enhancement of logistics ties with Taiwan by developing scheduled all-cargo service between the island and airports in Guangdong. Yang said that the cross-border trucking issue was specifically raised with Vice Governor Wan Qinliang, who expressed willingness to bring the issue before other Guangdong provincial officials.

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